

Record Penalty for Alleged Regulation FD Violations and Best Practices Going Forward

Published by *Capital Markets Compass* | Issue 5

February 15, 2023

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On December 5, 2022, a large telecommunications company (the Company) and the US Securities and Exchange Commission (SEC) agreed to settle long-standing charges that executives allegedly had selectively disclosed material nonpublic information (MNPI) to financial analysts in 2016, a violation of Regulation Fair Disclosure (Regulation FD). To settle the charges, the Company agreed to pay a record $6.25 million penalty, and three Company investor relations executives, who were charged with aiding and abetting the violations, each agreed to individual $25,000 fines.

Regulation FD

Regulation FD prohibits public companies from selectively disclosing MNPI. It applies to statements made by, or attributable to, a company – including statements by members of the board of directors, senior management or those acting under their direction. Generally speaking, Regulation FD requires that whenever a public company, or any person acting on its behalf, discloses MNPI to certain "enumerated" persons, such as securities analysts or institutional investors, that company must also either (i) simultaneously (for intentional disclosures) or (b) promptly (for non-intentional disclosures) disclose that same information to the general public. Violations of Regulation FD can result in SEC enforcement actions being brought against companies and individuals, which may result in monetary penalties or other forms of relief. The full text of Regulation FD is available here.

- ***What constitutes "material information" under Regulation FD?*** Information may be considered "material" under Regulation FD if there is a "substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision, or if that information "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[i] Materiality assessments under Regulation FD must

therefore take into account quantitative and qualitative factors, including the expected market reaction to information.

- ***What constitutes "nonpublic information" under Regulation FD?*** Under Regulation FD, information may be deemed "nonpublic" if it has not been disseminated in a manner that would make it available to all investors generally. Conversely, for information to be made public, "it must be disseminated in a manner calculated to reach the securities marketplace in general through recognized channels of distribution, and public investors must be afforded a reasonable waiting period to react to the information."[ii] Dissemination through "recognized channels of distribution" may include (i) disclosing the information in a press release, (ii) filing a Form 8-K that includes such information, (iii) publication of the information on a company website (if such website is one of the company's "recognized channels of distribution" or (iv) via social media (similar to disclosure on a company website if such social media platform is viewed as one of the company's "recognized channels of distribution").[iii]
- ***What constitutes an "enumerated person" under Regulation FD?*** It is important to note that Regulation FD is not a blanket prohibition on MNPI disclosures; rather, the rule only proscribes disclosures to (i) securities market professionals, such as brokers, dealers, investment advisers, institutional investment managers, and sell-side and buy-side analysts and (ii) shareholders, if it is reasonably foreseeable that they would trade on the basis of the information.

Regulation FD Oversight and Compliance

Senior management and public company director fiduciary duties include oversight of company policies protecting against breaches of federal securities laws and regulations. Part of such oversight responsibility includes overseeing a company's and its employees' compliance with Regulation FD. To strengthen compliance functions, many public companies adopt Regulation FD protocols, which provide specific guidance on timing, content, and methods of disclosure of any information that may constitute MNPI to prevent inadvertent securities violations. Such protocols typically establish (i) procedures for earnings releases and contact with securities analysts; (ii) guidelines for monitoring postings on a company's website and any social media outlets; (iii) rules requiring prior approvals of speeches and interviews of senior management or members of the board of directors; and (iv) processes for dealing with unintentional selective disclosures.

Recent Regulation FD Enforcement Action and Record Settlement

Although stand-alone Regulation FD enforcement actions are relatively rare, the SEC has brought several enforcement actions focusing on selective communications to analysts and shareholders surrounding earning estimates – and in particular, what could be considered "implied disclosures" and signaling with respect to such estimates – rather than outright disclosures of MNPI.

On March 5, 2021, the SEC charged the Company and three members of its Investor Relations department with violating Regulation FD by allegedly selectively disclosing to sell-side analysts internal sales data showing a larger-than-expected decline in smartphone sales, with an alleged goal of lowering the analyst's revenue estimates ahead of earnings. The original complaint is available here. Specifically, according to the SEC's complaint:

- In March 2016, the Company saw that a steeper-than-expected decline in its first-quarter smartphone sales would cause revenues to fall short of analyst expectations. The Company had missed consensus revenue estimates in two of the three preceding quarters.
- To avoid missing consensus estimates, the Company's Chief Financial Officer, according to the SEC, directed the Investor Relations department to "work the analysts who still have equipment revenue too high."
- Following such directive, three members of the Investor Relations team made private, one-on-one phone calls to approximately twenty sell-side analysts, disclosing internal smartphone sales data and their impact on internal revenue metrics.
- The Company's Regulation FD training materials noted smartphone revenues and data was generally considered "material" information.
- The director of the Company's Investor Relations department had his team track (a) each analyst's original first-quarter projection, (b) who was assigned to call each analyst and (c) any adjustments analysts made to their projections after the calls, with weekly internal meetings to discuss the effects of the outreach.
- Following the calls, each of the analysts reduced their revenue forecasts, resulting in the consensus estimate falling to just below the level the Company ended up reporting.

The Company contested the enforcement action, arguing that information about a slowdown in smartphone upgrades had already been publicly disclosed by the Company's Chief Financial Officer at an investor conference and claimed that employees who called the analysts just "wanted to make sure they had seen the Chief Financial Officer's earlier remarks." The Company also argued that information regarding an expected revenue drop was a publicly-known trend in smartphone sales caused by an industry-wide phase-out of subsidies for smartphone upgrades, and in any case, was immaterial, as it had less than a 5 percent impact on the Company's total revenue, which lawyers for the Company argued was a general threshold for whether a misstatement is considered material to investors. Finally, the Company further contended that the information disclosed was not material because, previously, missed consensus estimates had not considerably moved the stock price.

The Settlement

On December 5, 2022, the Company and the three members of the Investor Relations team who were charged with aiding and abetting the Regulation FD violations agreed to settle the case and pay fines without admitting or denying any of the alleged violations. The SEC noted in the press release announcing the settlement that the penalty agreed to by the Company was the largest ever recorded in a Regulation FD enforcement action, and the Director of the SEC's Enforcement Division specifically noted: "The actions allegedly taken by Company executives to avoid falling short of analysts' projections are precisely the type of conduct Regulation FD was designed to prevent… Compliance with Regulation FD ensures that issuers publicly disclose material information to the entire market and not just to select analysts."

Key Takeaways

Chairman Gensler's regime remains hyper-focused on reigning in what his administration has deemed aggressive market practices including compliance with respect to obligations under Regulation FD. Although most public companies have specific disclosure policies and guidelines in place, and management may even receive periodic training regarding Regulation FD compliance, many public companies tend to rely mostly on self-policing to monitor and ensure internal Regulation FD policies are enforced which can potentially result in inadvertent foot-faults. Regular training, policy reviews and on-going guidance regarding prohibited communications and disclosures should be viewed as proactive and necessary steps towards avoiding Regulation FD violations.

Specifically, with respect to the context of the Company's enforcement action, it is important to note that one-on-one calls with analysts and shareholders should merit particular caution when it comes to Regulation FD scrutiny – the Company had argued that the SEC did "not cite a single witness involved in any of [the] analyst calls who believe[d] that material nonpublic information was conveyed to them" – and yet the SEC still brought a case alleging that violations had occurred. Materiality for purposes of securities law is judged on an objective, “reasonable shareholder” standard – and the Company's case may be viewed as a reminder that even if both the provider and the recipient of MNPI believe that the information conveyed was not material to *them*, lack of materiality with respect to the individual is not dispositive or potentially cleansing of what would otherwise amount to a Regulation FD breach – materiality of information must in this context be viewed through a broader any "reasonable shareholder" lens.

The SEC also rejected the Company's arguments that the calls did no more than repeat publicly-known information, noting the context and timing of the calls (i.e., right before earnings were released) in of itself was enough to convey MNPI to the analysts, even if during the calls the employees merely pointed to publicly available information. The Company's settlement reemphasizes that companies and employees must remain vigilant regarding indirect guidance and signaling with

respect to earning estimates, and that companies should consider documenting both what is communicated during private calls and give consideration ahead of any such calls regarding whether any topics intended to be discussed may constitute MNPI.

i *See* TSC Industries, Inc. v. Northway Inc., 426 U.S. 438 (1976).

ii In re Faberge, Inc., 45 S.E.C. 249, 255 (1973). *See also* Regulation FD Adopting Release, supra note 41, at Section II.B ("Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.").

iii Note that in June 2012, then Netflix, Inc. Chief Executive Officer Reed Hastings was investigated by the SEC after making a post on his personal Facebook page disclosing certain metrics regarding streaming hours on the Netflix platform (and the stock moved up after his post). The SEC ultimately did not bring an enforcement action against Netflix or Hastings, but did reiterate that existing regulations provide company officials are only permitted to use social media to provide important information to the public in a Regulation FD-compliant manner if: (i) the outlets are viewed as "recognized channels of distribution" for communicating with the company's investors and (ii) the company first takes "steps sufficient to alert investors and the market to the channels it will use for the dissemination of material, nonpublic information." *See* the SEC's press release "SEC Says Social Media OK for Company Announcements if Investors Are Alerted" available here for further information.

If you have any questions regarding this article or would like your Katten team to provide a refresher on best practices regarding Regulation FD or training support, please do not hesitate to reach out.

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